Morgan Stanley

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From: Deepak Moorjani

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Introduction

More and more investors have discovered the appeal of REITs. Creatures of tax law, REITs provide transparency, liquidity, more permanent management and corporate structures, easier access to all forms of capital including unsecured debt, and greater overall property market efficiency.

Consolidation in the Japanese REIT sector seems more than likely when valuations fall. As a comparison, the overall market capitalization of US REITs grew from $44.3 billion to $224.2 billion during 1994 through 2003, but the number of REITs declined from a peak of 225 to less than 175. Australia provides another example of consolidation. In Australia, there are 80 listed LPTs and other property firms with a total market cap of over $50 billion, and LPTs control nearly half of the institutional quality commercial real estate in Australia. However, the sector is dominated by five LPTs which account for 40 percent of the sector's market capitalization. The top 10 LPTs make up more than 65 percent of the sector.

In 1997-98, US REIT NAV premiums hit peak highs around 25-30% premiums to NAV. These numbers declined in the REIT bear market of 1999-2000 when REIT stocks significantly underperformed the overall market. By early 2000, REITs valuations hit bottom and were trading at more than a 10% discount to NAV. In this environment, a number of large REIT LBO/MBO transactions were consummated including Berkshire Realty, Sunstone, Irvine, Walden Residential and Patriot American. More recently, Capital Automotive, Gables Residential and CRT Properties have approved plans to go private at premiums of 9-15% over market price in 2005. In Oct 2005, MSREF announced its intention to acquire AMLI Residential for $2.1 billion, a 21% premium to market and a 1.9% premium to Green Street NAV.

The Japan Market

Japan's Investment Trust Law, enacted in November 2000, established the REIT vehicle, and two REITs were listed in September 2001. Today, listed JREITs total 28, including 13 newly-listed JREITs since the beginning of the year. J-REIT expansion has been aided by the JGB yield gap coupled with the liquidity, current income yield and transparency of the investment vehicle.

In Japan, we expect to see continued growth in the REIT sector with the secular shift from private to public ownership of real estate. However, the large and growing number of funds in Japan might not be sustainable without some consolidation. As companies compete for deals, asset prices continue to rise and cap rates continue to fall thereby making it more difficult to generate the returns demanded by the public shareholders. The pressure to reach critical mass will increase: with size comes the ability to cover wider territory, to save on expenses, to lower the cost of capital, and to increase liquidity. Additionally, private real estate firms can use more leverage than counterparts in the public market which provides additional financial clout to bid on pricey deals. Couple these with the changing of the guard at many private empires, and consolidation is likely to occur.

Naysayers might argue that management entrenchment, tax concerns, poison pills, and a variety of other factors will prevent consolidation. These issues do exist and are real barriers. In addition, REITs are not cheap enough in the aggregate for the LBO/M&A business to grow dramatically at current valuations. However, I believe the

structure of the REIT group and the timing of the property and market cycles will put enough pressure on the industry to consolidate (and decapitalize) over the next several years; consolidation forces will overcome these impediments.

LBO Analytics

Let's take a look at how the numbers might work in a REIT LBO. As an intro, we should remember that a PMV/LBO valuation may not equal net asset value. As a simplifying assumption, we have assumed that a discount to NAV is necessary for an attractive transaction; however, this is a limiting and potentially misleading assumption for two reasons:

- REITs that trade at a discount to NAV are **not** always cheap; NAV discounts are not necessarily a strong buy signal. Instead of the gap being closed by a sharp rise in REIT prices, it might be closed by capitalization rates rising. In other words, rather than have rising real estate prices, real estate values might decline.
- REITs that trade at a premium to NAV are **not** always expensive. One can argue that public REITs offer more than asset value; REITs come with management teams and operating companies. Thus, there is asset value and potentially intangible value.

In any case, private market buyers must account for a number of items that require a discount on public expectations of NAV. The haircut is associated with potentially higher cap rate assumptions, debt prepayment penalties and origination costs, and transaction fees. Together, these items could amount to 5% of NAV and must be included in any analysis of private market value. Like most discounts, the buy-side will probably be ahead of the sell-side and BODs on this issue. Let's look at these three factors in more detail.

1. More conservative cap rate assumptions - Calculations of NAV are dependent upon cap rate assumptions, and market cap rates are reflective of prevailing market conditions. However, private market buyers often incorporate higher cap rates in order to account for higher internal rate of return requirements and higher capital expenditure reserve assumptions. Recall that private market buyers generally seek 20%+ leveraged internal rates of return (IRRs) for their funds. This IRR can be broken down into two parts: an initial cash-on-cash return and future growth. In other words, private market buyers will typically price an LBO with a higher cap rate than market expectations in order to achieve required return hurdles.

Most real estate funds are in the market on a daily basis purchasing properties. In order to generate interest in an LBO, private buyers would need to purchase the REIT's underlying assets below the levels they could achieve in the private market. That translates into more conservative assumptions regarding initial cash returns, future growth rates, and ultimately the resulting property level cap rates.

2. Debt fees and prepayment penalties - Many REITs have agreed to restrain from the use of excessive leverage for two reasons (i) implicitly to generate high dividend yields for the REIT investor base and (ii) explicitly to satisfy the requirements of credit ratings agencies, especially if there is any unsecured public debt. A small but growing number of REITs have obtained corporate credit ratings and issued unsecured public debt. These ratings carry certain stipulations on leverage. Also, most public note offerings contain certain debt covenants. Fixed charge coverage ratios, secured debt/total debt ratios, and debt/total asset ratios are three such debt covenants. As a consequence of this ratings process, many REITs have agreed to essentially restrain from the use of excessive leverage.

By definition, an LBO changes this with leverage in the 75-90% range. In order to accommodate more leverage, the balance sheet needs to be refinanced; existing debt must be repaid and new mortgage debt must be issued in its place. This movement of capital is costly in two ways. First, existing debt may carry prepayment penalties and

make-whole provisions which would have to be factored into the LBO valuation model. Second, secured debt in many cases carries origination fees which also would have to be factored into the LBO valuation model. The combined total of debt prepayment penalties and new origination fees could amount to 2% percent of transaction value.

Not all REITs, however, have issued unsecured debt. To the extent that a REIT has remained a secured borrower, these costs would be circumvented, thereby saving money which could accrue to the benefit of all constituencies, including new buyers and existing shareholders.

3. Transaction fees - On average, LBO transaction costs could add as much as 3% to the total transaction value. Transaction fees are associated with legal, accounting, due diligence, and investment banking advisors. In most cases, private market buyers would factor (deduct) these costs when pricing the deal and would work them into their IRR expectations. We incorporate these fees into our analysis as well.

Financial Arbitrage

Despite transaction costs and a higher cap rate, a JREIT LBO still makes financial sense with NAV discounts around 10-20%. The reason is simple: **Leverage.** REIT investors want high-current income, and REITs must leverage in order to maintain high dividend payments. An LBO is a significant financial restructuring with an investor base that does not need or want the current income stream. In the following cases, we incorporate similar deal and transaction costs.

- In Case A, we have shown a scenario roughly equivalent to the average public J-REIT market now stands: 35% leverage, a 4% cap rate and 3% NOI annual growth. The model shows an initial cash-on-cash yield of 5% and an ending IRR of 8%.
- In Case B, we examine a simple LBO calculation with the same operating assumptions as Case A with 85% leverage and a higher cap rate of 5%. Under this scenario, we calculate an initial cash-on-cash return of 3.85% and an IRR of 29%. To make the deal work at the various premiums, an LBO buyer needs:
  - A 20% discount to NAV with a 1% cap rate premium
  - A 15% discount to NAV with a 0.75% cap rate premium
  - A 10% discount to NAV with a 0.50% cap rate premium was than the LBO buyer would only need.

Note that this analysis only considers the benefit of financial arbitrage. It does not include management arbitrage which might be significant depending on the identity of the seller. We have assumed a modest 3% yearly growth in NOI.

An examination of **US REIT M&A transactions** reveals that going-private REIT transactions have been consummated at a median 16% premium to market price and **an 8.6% median premium to Green Street NAV calculations.** In fact, there are very few examples of completed transactions at a discount to NAV, and on a case-by-case basis, we should assume that will be the ability to generate some level of management arbitrage via economies of scale, altered fee structure, or other avenue. A further study of U.S. financial buyer transactions and sources of value is forthcoming.

Governance Issues

Given the public market status of REITs, we need to consider the corporate governance issues pertaining to LBOs/MBOs for REITs. How can a transaction be priced so that it is acceptable to private market buyers and REIT shareholders? The REIT BOD safeguards shareholders against insufficiently priced deals including the LBO priced

below NAV shown in Case B. On the other hand, private market buyers may only be interested in sponsoring an LBO/MBO if pricing is opportunistic (i.e., below NAV). If REITs are only motivated to sell in the event of a fully priced deal, and buyers are only motivated to step up in the event of a compelling discount, can these deals happen?

A "do-nothing" strategy may not be in the best interests of shareholders. Certain companies would trade down to even lower levels if they announce that they are “not for sale.” In many cases, the correct decision would be to sell the company, even if pricing only enhanced rather than maximized shareholder value. Suppose REIT A was trading at a 20% discount to recently published NAV estimates and was either rumored or known to be exploring strategic alternatives, including an LBO/MBO. Let’s also suppose that a private market buyer was willing to pay a 10% discount to NAV in an LBO. Holding to the strictest of guidelines, REIT A’s BOD could spurn the LBO offer in hopes of a bid at NAV. If the BOD disclosed this to shareholders, REIT A stock would likely trade down even further. Most shareholders would be in no mood for more downside risk and would be more than willing to part with their shares at reasonable (short of maximal) pricing. In real estate terminology, shareholders would be willing to sell shares into a cash LBO at a reasonable (5 to 10 percent) discount to NAV. The alternative of share prices trading down another 10 percent or more would be far worse.

In the J-REIT sector, the investor base is approximately 42% foreign, 43% retail and 15% domestic institutions. We can assume that REIT shareholders will be sufficiently motivated by price.

Structural and Other Issues

The MSREF/PRIME acquisition of AMLI was structured as a take-private acquisition by a private REIT. The offer is at a 1.9% premium to NAV, and the transaction was structured to allow PRIME a step-up in tax basis.

We are considering a JREIT LBO scenario where **the resulting structure is not a private JREIT**. While private REITs are increasingly popular in the US, the private JREIT market does not exist in Japan. Furthermore, the structure should be unnecessary for MSREF. REITs are a tax-efficient way for certain investors to own real estate. If a private buyer can solve those same issues in an alternate way, the tax-advantaged structure of the REIT is probably not necessary. Current law is silent on REIT transactions, and internal checks indicate that a partnership acquisition of a JREIT should work. *Additionally, we have asked counsel at NOT to do a quick analysis for any legal hurdles that might stand in the way.*

Beyond legal issues, a JREIT deal needs to consider the element of personality. In many cases, these companies were founded as private companies with successful entrepreneurs who are used to being in control. Additionally, many of these people want the status that is provided by running a public JREIT.

Conclusion/Next Steps

A going-private JREIT transaction is simply taking advantage of private market/public market arbitrage when stock market and/or sector valuations decline. Currently, TOPIX is at 5-year highs, and despite the frenzy, some JREITs are trading below NAV. This situation probably worsens over time. As a private buyer, the financial restructuring of an LBO creates value, and it is a very efficient way to acquire a large portfolio of assets. It need not be the final step: the exit could simply be a new JREIT offering when public market values increase.

Currently, the residential sector seems to be most vulnerable. Names worth watching include Japan Single Residence (Creed), Propect Residential, New City Residence (CBRE), FC Residential (Fund Creation), and DA Office (DaVinci).